IN THE

Supreme Court of the United States

October Term, 1942

No. 22

GUY T. HELVERING
Commissioner of Internal Revenue
Petitioner
vs.
R. A. SPROUSE
Respondent

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

Opinions Below

The opinion of the Board of Tax Appeals (R. 19-33) is reported in 42 B. T. A. 484. The opinion of the Circuit Court of Appeals (R. 50-54) is reported in 122 F. (2d) 973.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on October 22, 1941 (R. 55). The petition for a writ of certiorari was filed on January 21, 1942; it was denied on March 2, 1942, and a petition for rehearing was denied on March 30, 1942. On May 11, 1942, the order denying certiorari was vacated and the petition was granted. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

Whether the owner of voting common stock of a corporation, which had only voting common and nonvoting common stock outstanding, realized taxable income upon the receipt of a stock dividend based upon corporate earnings and paid in nonvoting common stock of the corporation.

Constitutional Provisions, Statute, and Regulations Involved

The constitutional provisions, statute, and regulations involved are set forth in the Appendix, infra, pp. 46-51.

Statement

The statement of the case in the petitioner's brief (Petitioner's Brief pp. 2-4) is correct[1] but should be amplified by certain additional facts as stipulated (R. 12-19) and as found by the Board (R. 21-25). These additional facts may be summarized as follows:

At the time of the payment of the stock dividend on February 13, 1936, the authorized capital stock of Sprouse-Reitz Co. Inc. consisted of three classes of shares: voting common stock, nonvoting common stock, and nonvoting seven per cent. preferred stock (R. 21, 22). Only voting common stock and nonvoting common stock were outstanding at that time, none of the authorized preferred stock having been issued (R. 21). The corporation's articles of incorporation contained the following provision (R. 22):

> "The preferred stock shall be entitled to a dividend of 7 percent annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

[1] Petitioner has called attention to a slight variance between Finding 5 (R. 23) and Finding 3 (R. 22) (Pet. Br. p. 3, ftn. 2). Finding 5 was correct. The distribution of nonvoting common stock was in proportion to the respective stockholdings of both classes. Through inadvertent error the specific figures used in Finding 3 were incorrect.

The preferred stock and the nonvoting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

SUMMARY OF ARGUMENT

I

The stock dividend in this case is not taxable under the rule of *Eisner v. Macomber* as affirmed by *Koshland v. Helvering* and *Helvering v. Gowran.*

A. This Court held in *Eisner v. Macomber*, 252 U. S. 189, that appreciation in the value of a capital asset was not income; that there must also be some change in the form or extent of the investment; and that a stock dividend which did not alter the stockholder's pre-existing interest in the corporation did not constitute income.

B. The basic doctrine of *Eisner v. Macomber* was affirmed by this Court in later cases involving the taxability of stock dividends. *Koshland v. Helvering*, 298 U. S. 44; *Helvering v. Gowran*, 302 U. S. 238.

Under that basic doctrine the stock dividend received by the respondent in the instant case was not income since it left his pre-existing interest in the corporation unchanged.

II

Eisner v. Macomber was correctly decided. Stock dividends which do not change the form or extent of the taxpayer's investment do not constitute income.

A. The question presented by the instant case is whether the stock dividend received by the respondent constituted income within the meaning of the Sixteenth Amendment. The Sixteenth Amendment authorizes an unapportioned tax only on what is actually income. If the stock dividend here involved was not income under the Sixteenth Amendment, it was not taxable under Section 115 (f) (1) of the Revenue Act of 1936.

B. The holding of the *Macomber* case that to constitute income a stock dividend must change the form or extent of the stockholder's interest has been tested and approved by this Court in subsequent cases rather than repudiated as the petitioner asserts.

C. The concept of income developed in *Eisner v. Macomber* is logically sound and contributes to efficient administration of the income tax laws.

III

In amending Section 115 (f) Congress intended to exempt from tax stock dividends of the type involved in the present case and in *Eisner v. Macomber*.

A. Where a question exists as to the proper construction of a statute, the Courts will if possible adopt that construction which will avoid a substantial constitutional question.

B. The circumstances surrounding the enactment of Section 115 (f) (1) of the Revenue Act of 1936 disclose that Congress did not intend to tax stock dividends of the type involved in the *Macomber* case and in the present case. Correctly construed to give effect to this congressional intent, Section 115 (f) (1) exempts from tax the stock dividend here involved. There is no occasion, therefore, for this Court to consider or decide the grave constitutional questions raised by the petitioner.

C. Even if petitioner's argument that *Eisner v. Macomber* is erroneous be conceded, the original intent of Congress in enacting Section 115 (f) (1) must still be given effect and stock dividends like that in the case at bar held to be nontaxable.

ARGUMENT

I

The stock dividend in this case is not taxable under the doctrine of Eisner v. Macomber, as affirmed by Koshland v. Helvering and Helvering v. Gowran.

The question of the taxability of stock dividends under an income tax statute has been directly before this Court in four cases during the past twenty-two years: *Eisner v. Macomber*, 252 U. S. 189; *Koshland v. Helvering*, 298 U. S. 441; *Helvering v. Gowran*, 302 U. S. 238; and *Helvering v. Pfeiffer*, 302 U. S. 247. The Circuit Court of Appeals correctly held that under the rule of those decisions the stock dividend in the instant case was not taxable to the respondent.

In *Eisner v. Macomber*, supra, this Court held that a dividend of voting common stock distributed on voting common stock did not constitute "income" to the recipient and could not be taxed under the applicable income tax law. The basic reasoning of the majority opinion is that mere increase in value of an investment in corporate stock is not converted into income by the distribution of a stock dividend which does not alter the stockholder's pre-existing proportional interest in the corporation. *Eisner v. Macomber*, pp. 211, 212.

The test announced in *Eisner v. Macomber* was not repudiated in *Koshland v. Helvering*, 298 U. S. 441, nor in *Helvering v. Gowran*, 302 U. S. 238, and *Helvering v. Pfeiffer*, 302 U. S. 247; it was merely rephrased and somewhat refined. In *Koshland v. Helvering*, supra, this Court, after referring to the broad interpretation placed on the *Macomber* case by the Treasury Department and to a provision in the Revenue Act of 1921 exempting all stock dividends from tax, said (p. 445):

> "Soon after the passage of that act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest."

In a subsequent portion of the opinion the same idea was more affirmatively expressed as follows (pp. 445, 446):

> "Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new cer-

tificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes."

It will be noted that the opinion in the *Koshland* case carefully points out that not all stock dividends constitute income, and states particularly that a dividend in common shares is not income where it does not alter the stockholder's "proportionate interest in the net assets of the corporation." The requirements for a nontaxable stock dividend as thus stated are met by the dividend here involved.

When the stock dividend in the instant case was declared, the corporation had outstanding only voting common and nonvoting common stock (R. 22). Each of these classes of common stock was equally entitled to regular dividends and likewise shared equally in the net assets of the corporation on liquidation (R. 22). The stock dividend in question was in nonvoting common stock distributed ratably to holders of voting common and nonvoting common shares (R. 23).

Obviously, under these conditions the distribution to the respondent of nonvoting common shares as a dividend on his voting common stock did not confer on him any new or different rights and did not alter the nature or extent of his interest in the corporation. Since the dividend was paid ratably to all stockholders, it did not disturb in the slightest degree the relationship previously existing among those stockholders, or the relationship previously existing between the respondent and the corporation. After the distribution of the dividend shares the respondent was entitled to the same number of votes, to the same proportion of the total votes, to the same proportionate share of regular dividends, and to the same actual and proportionate participation in liquidating dividends as he was entitled to prior to his receipt of the nonvoting shares.

The dividend changed neither the kind nor quantity of the respondent's interest in the corporation; in effect, his former property interest was simply restated. The position of the respondent in relation to the corporation and to the other stockholders immediately following the payment of the stock dividend in nonvoting common stock cannot be distinguished from the position of the taxpayer Macomber after her receipt of the stock dividend held nontaxable in *Eisner v. Macomber*, supra.

The petitioner asserts that the stock dividend here involved was income to the respondent under *Koshland v. Helvering*, supra, because "the new stock represented an interest different in kind from that theretofore held by the respondent" (Pet. Br. p. 6). But this argument misinterprets the *Koshland* decision. The opinion in that case does not say that *any* change in the nature of the shares issued as dividends will render the stock dividend taxable to the recipient. To make the dividend taxable, there must be "a change in the nature of the shares issued as dividends *whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.*" *Koshland v. Helvering*, supra, p. 445. (Italics supplied)

As shown above, the dividend paid to the respondent in nonvoting common shares did not change the extent of his interest in the corporation or work any change in his entire capital interest in the corporate enterprise. This case falls squarely within the statement in the *Koshland* opinion that "the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation

as did the old, does not constitute the receipt of income by the stockholder." *Koshland v. Helvering*, supra, p. 446.

II

Eisner v. Macomber was correctly decided. Stock dividends which do not change the form or extent of the stockholder's investment do not constitute income.

The petitioner's brief in this case charges that *Eisner v. Macomber*, supra, was erroneously decided and should be overruled. For a discussion of this issue petitioner refers the Court to his answering brief in *Strassburger v. Helvering*, No. 66, in which he has inserted a lengthy argument dealing generally with the power to tax granted Congress by the Constitution.

We submit, however, that even if this Court should conclude to re-examine its long-standing decision in *Eisner v. Macomber*, that re-examination would not properly involve a review of the broad constitutional questions posed by the petitioner's answering brief in the *Strassburger* case. (Strassburger Br. pp. 14-23.) So far as the present case provides a vehicle for the

For convenience, the brief of the Commissioner of Internal Revenue in *Strassburger v. Helvering*, No. 66, will be cited herein as "Strassburger Br."

re-examination of *Eisner v. Macomber*, it does so by presenting a problem of statutory construction. The statutory provision in question is Section 115 (f) (1) of the Revenue Act of 1936, which provides:

> "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

Clearly, this section turns us back to the meaning of the term "income" in the Sixteenth Amendment. The petitioner, acting on the erroneous assumption that the section makes taxability co-extensive with constitutional power (Strassburger Br. p. 11), has attempted to go further and to explore the larger question of the constitutional power of Congress to tax stock dividends without reference to their status as income. (Strassburger Br. pp. 14-23.) We are not here concerned with that question. It is in no way involved in this case.

In *Pollock v. Farmers Loan & Trust Co.*, 158 U. S. 601 (1895), this Court held that taxes upon real or personal property or upon the income derived from

such property were direct taxes and invalid unless apportioned as required by Article I, Section 9, Clause 4 of the Constitution. The Sixteenth Amendment eliminated the requirement of apportionment only with respect to federal taxes on incomes and left unchanged the holding of the *Pollock* case that a tax on real or personal property must be apportioned. *Brushaber v. Union Pacific Railroad Company*, 240 U. S. 1, 17-19; *Stanton v. Baltic Mining Company*, 240 U. S. 103, 112; *Peck & Co. v. Lowe*, 247 U. S. 165, 172, 173; *Eisner v. Macomber*, 252 U. S. 189, 206. It follows that the power of Congress under the Sixteenth Amendment to impose an unapportioned tax is confined to the taxation of "income" in the proper sense, and does not extend to income enlarged by artificial definitions to include what is not in fact income.

The statutory provision, Section 115 (f) (1), *supra*, under which the petitioner seeks to impose a tax on the stock dividend received by the respondent.

While the *Pollock* case directly involved only a tax on incomes, the majority opinion clearly set forth the basic proposition that taxes on real or personal property are direct. See 158 U. S. 601 at 618, 628, 629, 634. Compare Mr. Justice Jackson's dissent in 158 U. S. 601 at 696. See also majority opinion in first *Pollock* case, 157 U. S. 429, 574.

is a part of the Income Tax Title[1] of the Revenue Act of 1936. Moreover, Section 115 (f) (1) refers expressly to stock dividends which constitute "income" within the meaning of the Sixteenth Amendment. The sole question involved in petitioner's attack on *Eisner v. Macomber* is, therefore, whether the stock dividend received by the respondent is "income" under the Sixteenth Amendment.

Both the majority opinion and the minority opinion[2] in *Eisner v. Macomber*, supra, seem to recognize that Congress may not exceed the bounds of the power conferred by the Sixteenth Amendment and define as income that which does not in fact constitute income. The disagreement within the Court in the *Macomber* case was not with respect to the issue to be resolved. All were agreed that the question was whether a stock dividend constituted income. The divergence between the prevailing and dissenting opinions was only as to the correct answer to that question. In answering the question in the negative,

[1] Title I of the Revenue Act of 1936, c. 690, 49 Stat. 1652, is headed "Income Tax." Section 115 (f) (1) is under this heading: c. 690, 49 Stat. 1688.

[2] 252 U. S. 189, at 219.

[3] 252 U. S. 189, at 225.

the majority opinion by Mr. Justice Pitney adopts the view that mere appreciation in value of corporate stock is not income to the shareholder until realized through some change in the form or extent of his interest in the corporation.

On this question of whether a stock dividend of the *Macomber* type represents income, the petitioner argues that this Court has held in *Collector v. Hubbard*, 12 Wall. 1, that Congress has power to tax a stockholder on his proportionate interest in the undivided corporate earnings as they accrue. (Strassburger Br. pp. 25-30.) From this he concludes that the receipt by a stockholder of a stock dividend representing those earnings must constitute taxable income to the shareholder. (Strassburger Br. p. 25.) We believe that petitioner's interpretation and application of the *Hubbard* case is erroneous.

The case of *Collector v. Hubbard*, supra, arose under the Internal Revenue Act of 1864, which provided that the gains or profits of certain companies should be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise. The object of this provision was to insure the payment of a tax upon the

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c. 173, 13 Stat. 223, 281.

earnings of the corporation (See *Gibbons v. Mahon*, 136 U. S. 549, 560), since the tax thus levied on the shareholders was the only tax imposed with respect to corporate earnings.

In the *Hubbard* case, which was decided twenty-five years before *Pollock v. Farmers Loan & Trust Co.*, supra, no question was raised of the constitutional power of Congress to tax incomes or property. Accordingly, the Court found it unnecessary to determine the nature of the increase in the value of a shareholder's stock attributable to his interest in the undivided corporate profits and merely held that such profits were property and were taxable. *Collector v. Hubbard*, supra, at 18.

On the other hand, the holding in the *Pollock* case, the language of Section 115(f) (1), and the language of the Sixteenth Amendment all make it necessary to distinguish in the case at bar between a tax on income and a direct tax on the capital investment of the stockholder. Further, the tax statute in the *Hubbard* case is so fundamentally different from the provisions of the Revenue Act of 1936 applicable to the present case that the *Hubbard* decision becomes irrelevant. As noted above, the Act of 1864 imposed no tax on corporations but merely attempted to reach

corporate earnings by taxing them to the shareholders when they accrued. The Revenue Act of 1936, however, far from disregarding the corporate entity for tax purposes, makes that entity a basic part of the income tax structure by taxing corporations directly on their incomes.[7] It is a contradiction of the terms of the statute to regard the corporate earnings as being income to two taxpayers—the corporation and its shareholders—simultaneously.[8] So far as a stockholder is concerned, the earnings merely represent an increase in the value of his capital investment and do not become realized income to him until there is a change in the form or extent of that investment.

The petitioner also sharply challenges the reasoning of the majority opinion in *Eisner v. Macomber*.

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[7] See Sections 13 and 14, Revenue Act of 1936, c. 690, 49 Stat. 1648, 1655.

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[8] See Powell, Stock Dividends (1920), 20 Col. L. Rev. 536, 542. The entire plan of the taxing statute refutes the theory that the same earnings are taxable to two taxpayers as they accrue. Under the partnership provisions of the 1936 Act, for example, no tax is levied on the partnership income as such. The partnership is merely regarded as an accounting entity the income of which is to be computed and taxed to the individual partners, whether distributed or not. See Sections 181, 182, 183, Revenue Act of 1936, c. 690, 49 Stat. 1648, 1709. This treatment of partnerships for tax purposes is the basis of this Court's decision in Heiner v. Mellon, 304 U. S. 271, 281, cited by petitioner (Strassburger Br. p. 26).

(Strassburger Br. pp. 31-41.) He asserts that such later decisions of this Court as *Koshland v. Helvering*, supra; *United States v. Phellis*, 257 U. S. 156; *Rockefeller v. United States*, 257 U. S. 176; *Cullinan v. Walker*, 262 U. S. 134; *Weiss v. Stearn*, 265 U. S. 242; and *Marr v. United States*, 268 U. S. 536 (1925), have repudiated the rationale of the *Macomber* decision. (Strassburger Br. pp. 31, 32.) The fact is that in all of the cases just mentioned this Court expressly considered the doctrine of the *Macomber* case and in some degree restricted its scope. But in each of these decisions the Court confirmed and left intact the fundamental rule that a stockholder does not realize income upon receipt of a stock dividend which does not change his interest in the corporation.

As recently as 1936, in the *Koshland* case, this Court has said that the test in determining the taxability of stock dividends is whether it changes the proportionate interest of the stockholder in the corporation. *Koshland v. Helvering*, supra, p. 445. As shown in the first portion of this brief, supra, p. 11, this test clearly affirms the nontaxable character of the stock dividend in *Eisner v. Macomber* and likewise of the stock dividend involved in the present case.

The five remaining cases listed above involved corporate reorganizations and in each of them the rationale of *Eisner v. Macomber* was subjected to searching scrutiny. In *Marr v. United States*, supra, the last of these cases in point of time, the prevailing opinion of Mr. Justice Brandeis represents a crystallization of the conclusions which the Court had been evolving in the preceding cases. The majority opinion in *Marr v. United States*, supra, states in part (pp. 540, 542):

> "In each of the five cases named, as in the case at bar, the business enterprise actually conducted remained exactly the same. In United States v. Phellis, in Rockefeller v. United States, and in Cullinan v. Walker, where the additional value in new securities distributed was held to be taxable as income, there had been changes of corporate identity . . . In Eisner v. Macomber and in Weiss v. Stearn, where the additional value in new securities was held not to be taxable, the identity was deemed to have been preserved . . .
>
> In the case at bar, the new corporation is essentially different from the old . . . The case at bar is not one in which after the distribution the stockholders have the same proportional interest of the same kind in essentially the same corporation."

The net result of these reorganization cases was to re-examine and clarify the doctrine of *Eisner v. Macomber* by testing it against varying fact situations.

Thus, this Court found that the test prescribed by the *Macomber* case was not met in the *Phellis, Rockefeller, Cullinan,* and *Marr* cases because the dividend in each of those cases resulted in a change in the kind or extent of the interest of the shareholder. In *Weiss v. Stearn*, supra, the *Macomber* test was held to be satisfied because of the substantial identity of the stockholder's interest before and after the distribution of the dividend shares. In each of these decisions[10] the Court gave careful consideration to the validity of the *Macomber* case and approved the basic doctrine of the majority opinion in that case. There is therefore no substance in the petitioner's assertion that the cases discussed above have repudiated the majority opinion in *Eisner v. Macomber.*

The petitioner next contends that *Eisner v. Macomber* erroneously holds that there can be no income unless it is "severed from" capital. (Strassburger Br. pp. 34-39.) It is apparent, however, that this requirement of "severability" is merely another way of saying that appreciation in the value of corporate stock is not income to the stockholder until it is

[10] *United States v. Phellis*, 257 U. S. 156 at 169, 170, 175; *Cullinan v. Walker*, 262 U. S. 134 at 137; *Marr v. United States*, 268 U. S. 536 at 540; *Weiss v. Stearn*, 265 U. S. 242 at 253, 254; *Rockefeller v. United States*, 257 U. S. 176 at 183, 184, decided on authority of *U. S. v. Phellis*, supra.

realized."[11] Under the *Macomber* case doctrine realization requires that the stockholder receive something distinct and different from his original investment.[12] Thus, a stock dividend which works no change in the form or extent of his investment—i.e., does not alter his proportional interest in the corporate assets—does not constitute income.

Correctly viewed, therefore, the "severability" requirement of the *Macomber* case has not been destroyed by subsequent decisions of this Court, such as those holding that the satisfaction of indebtedness for less than par may result in taxable income to the debtor. (Strassburger Br. p. 36.) The *Macomber* case was concerned with appreciation in the value of a capital asset. A majority of the Court found that the appreciation did not constitute income until there was some change in the form or extent of the taxpayer's interest. In cases such as *United States v. Kirby Lumber Company*, 284 U. S. 1 (1931), and *Helvering v. American Chicle Company*, 291 U. S. 426 (1934) (Strassburger Br, pp. 36-37), the satisfaction of obligations at less than par was itself an

[11] See the discussion of *Eisner v. Macomber* in Magill, Taxable Income (1936), p. 40.

[12] See 252 U. S. 189 at 209, 211.

income-producing transaction and thus could properly be found to result in taxable income to the debtor. In the *Kirby Lumber Company* case, supra, this feature of the transaction was noted by Mr. Justice Holmes in the following statement (284 U. S. at p. 3):

> "Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct."

Similar income-producing transactions are present in the other examples cited by the petitioner, including the payment of a taxpayer's taxes and other obligations by a third person or the discharge of a mere "social duty." (Strassburger Br. p. 36.) To the extent that there is involved in these cases any appreciation in the value of a capital investment, the appreciation is a direct consequence of an event which produces income. On the other hand, the petitioner has stated directly that the "declaration of a stock dividend is not an income-producing transaction." (Strassburger Br. p. 7.) Because of this complete lack of analogy, we submit that these cases are not pertinent to a discussion of the soundness of the majority opinion in *Eisner v. Macomber.*

The petitioner relies most strongly in this portion of his argument upon *Helvering v. Bruun*, 309 U. S. 461, in which this Court held that upon repossession of leased premises after default, a lessor realized income to the extent of the value of a building erected on the land by the tenant. (Strassburger Br. pp. 37-38.) It is obvious that in this case the building represented an increase in the value of the lessor's land, but it is likewise clear that under the *Eisner v. Macomber* test the appreciation in value was "realized" by the lessor when he recovered the premises on default.

Prior to his repossession the lessor's interest was that of owner of the land and building, subject to the leasehold. After repossession, his interest was that of owner in fee simple. Thus he realized income under the *Macomber* test when he recovered the premises because the repossession changed both the form and extent of his pre-existing interest. Indeed, the opinion of this Court in the *Bruun* case indicates that this distinction was in the Court's mind; for the attempt of the taxpayer Bruun to rely on a supposed analogy with the stock dividend cases was dismissed with the following statement (pp. 468-469):

> "These expressions, however, were used to clarify the distinction between an ordinary dividend

and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder's interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here."

In the final portion of his attack on *Eisner v. Macomber* the petitioner criticizes the "misconception" that a stock dividend does not constitute "income" because the stockholder's position after the dividend was the same as before. (Strassburger Br, p. 39.) The discussion in the foregoing paragraphs constitutes in large measure an answer to this portion of petitioner's brief.

It was clearly the opinion of the majority of this Court in *Eisner v. Macomber* that the mere appreciation in the value of an investment does not constitute income,[11] but that there must also be some change

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[11] See Mr. Justice Pitney's statement that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." 252 U. S. 189 at 214, 215.

This Court reached a similar conclusion under the Income Tax Law of 1867, c. 139, 14 Stat. 478. Thus, in *Gray v. Darlington*, 15 Wall. 63, it was said (p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of a tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital."

See also *Lynch v. Turrish*, 247 U. S. 221, 230 (1918).

in the form or extent of the taxpayer's investment. Applying these concepts, this Court held that a stock dividend which does not alter the stockholder's interest in the corporation was not income. It should be noted that the same test would not exempt cash dividends from tax, as the petitioner implies. (Pet. Br. p. 6; Strassburger Br. p. 46.) The payment of a cash dividend unmistakably changes the form and extent of a taxpayer's investment, and under the *Macomber* rule constitutes income to him.

It is a fair deduction from the several opinions in *Eisner v. Macomber* that the majority and minority groups of the Court agreed that income must be "realized." Their disagreement went to the question whether a stock dividend which worked no change in the stockholder's pre-existing interest constituted "realization" of the increase in the value of his investment. Compare 252 U. S. 189 at 211 with 252 U. S. 189 at 229, 230. The holding of the majority was that a stockholder does not realize income unless the stock dividend alters the form or extent of his interest in the corporation.

Stated in more general terms, the doctrine of *Eisner v. Macomber* makes the determination of whether income is realized from the increase in value of a

capital asset depend on whether there has been any change in the form or extent of the taxpayer's interest in the asset. The result of applying the doctrine is to draw a line on one side of which income is said to be realized and on the other side of which the increase is said to remain capital. The validity of the doctrine may be tested therefore by examining the justification for drawing the line at this point.

From the standpoint of fundamental concepts of income the rule adopted by a majority of this Court in the *Macomber* case rests on a solid logical foundation. In distinguishing between capital and income, Justice Pitney in the prevailing opinion regards as capital the entire investment of the stockholder, including any increase in the value of that investment.[14] A stock dividend which works no change in the form or extent of the stockholder's investment, but merely restates it, does not alter the essential character of the stockholder's interest in the corporation. The increase in value is still capital. There has been no "realiza-

[14] See his statement at 252 U. S. 206, 207, that—

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time . . ."

tion." Therefore, a stock dividend of this type is not reached by a tax on "income."[15]

The petitioner asserts, however, that the problem of "realization" is "one of finding an appropriate time for the measurement of an increase in wealth." (Strassburger Br. p. 38.) In other words, an increase in the value of a capital asset should be regarded as income at any time when the taxing authority believes it can be appropriately and conveniently measured. (Strassburger Br. p. 38.) The result of such a rule would be to discard the fundamental concepts on which *Eisner v. Macomber* is based and to substitute therefore a test of administrative convenience.

If the petitioner's suggestion were adopted and the existence of income, and the time when it should be taxed, made to depend on administrative convenience rather than on the *Macomber* doctrine of realization,

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[15] See *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509, 520 (1921), where the Court in sustaining an income tax on capital gain from the sale of property, referred to "that 'realized gain' which has been repeatedly declared to be taxable income within the meaning of the constitutional amendment and the Acts of Congress."

[16] See *Commissioners of Inland Revenue v. Blott*, 2 A. C. 171 (1921), in which the House of Lords arrived at a similar conclusion under the British Finance Act (1909-10) 1910 (10 Edw. 7, c. 8). Several of the judges in the House of Lords referred approvingly to Mr. Justice Pitney's "most interesting and instructive judgment" in *Eisner v. Macomber*.

confusion and uncertainty would be introduced into the income tax law. On the other hand, the holding in *Eisner v. Macomber*, in addition to being based on a sound concept of income, has contributed to the efficient operation of the federal income tax system. Where a capital asset has increased in value, that increase becomes realized income[17] under the *Macomber* test only when there has been a change in the form or extent of the taxpayer's interest in the asset. Thus, taxpayers and tax authorities alike can easily determine the moment of realization under the test.[18] To the taxpayer the doctrine gives the advantage of stability and certainty and to the tax collector the advantage of easy administration.

We submit that the holding of the majority of this Court in *Eisner v. Macomber* was correct: that appreciation in the value of a stockholder's capital investment in a corporation is not income; and that a stock dividend which does not change but merely restates that investment is likewise not income.

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[17] See the conclusion of Powell in Constitutional Aspects of Income Taxation, The Federal Income Tax (1921), p. 82, that "'Realized gain' is a pretty sensible definition of income for a practical man, however it may seem to an expert conceptualist."

[18] Magill, Taxable Income (1936), pp. 66, 67.

III

In enacting Section 115 (f) (1) of the Revenue Act of 1936 Congress did not intend to tax stock dividends of the type involved in Eisner v. Macomber and in the case at bar.

The petitioner has devoted the greater part of his brief in the *Strassburger* case to an attack on the decision of this Court in *Eisner v. Macomber* and has requested that Congress be declared to have the constitutional power to tax all stock dividends. (Strassburger Br. pp. 21, 22.) In making this argument he has assumed that if *Eisner v. Macomber* is overruled the stock dividend in the case at bar would automatically become subject to tax under the Revenue Act of 1936.

We submit that a decision in the present case does not require such drastic measures as overruling a long-standing decision of this Court or re-examining the vexed constitutional questions which the petitioner propounds. It is the settled practice of this Court in all cases involving the construction of statutes to adopt, if reasonably possible, that construction which will avoid raising a grave constitutional question. *Shwab v. Doyle*, 258 U. S. 529 (1922); *Missouri Pac. R. Co. v. Boone*, 270 U. S. 466 (1926); *United States v. Delaware and Hudson Company*, 213 U. S. 366 (1909). The principle is stated by Mr. Justice

White in the *Delaware and Hudson* case as follows (p. 408):

> "It is elementary when the constitutionality of a statute is assailed, if the statute be reasonably susceptible of two interpretations, by one of which it would be unconstitutional and by the other valid, it is our plain duty to adopt that construction which will save the statute from constitutional infirmity. Knights Templars' & M. Life Indemnity Co. v. Jarman, 187 U. S. 197, 205, 47 L. ed. 139, 145, 23 Sup. Ct. Rep. 108. And unless this rule be considered as meaning that our duty is to first decide that a statute is unconstitutional, and then proceed to hold that such ruling was unnecessary because the statute is susceptible of a meaning which causes it not to be repugnant to the Constitution, the rule plainly must mean that where a statute is susceptible of two constructions, by one of which grave and doubtful constitutional questions arise and by the other of which such questions are avoided, our duty is to adopt the latter. Harriman v. Interstate Commerce Commission, 211 U. S. 407, 53 L. ed. ..... 29 Sup. Ct. Rep. 115."

This rule is particularly applicable in the instant case. The question of the constitutional power of Congress to tax the stock dividend here involved does not arise unless it is first found that in enacting the applicable provision of the Revenue Act of 1936 Congress did in fact intend to tax dividends of the type received by the respondent Sprouse. Thus, the pri-

mary issue in this case is not one of constitutional law but of statutory construction. Cf. *Towne v. Eisner*, 245 U. S. 418 (1918). We submit that it is reasonably open to this Court to find, and that therefore under the principle expressed in the *Delaware & Hudson* case it should find, that Congress at the time it amended Section 115(f) did not regard stock dividends of the *Macomber* type as income and that it enacted the amended section with the understanding that such dividends would not be taxed.

If this was the legislative intent, there is no occasion for the Court to take up the larger constitutional issues which petitioner seeks to raise. Whether the stock dividend here involved is income or, if not income, whether it can be taxed without apportionment, are questions which do not become relevant unless Congress has sought to subject it to tax.

The principle is firmly established that in construing a statute the Court will look to the circumstances surrounding its enactment and the particular evils at which it was aimed. *Apex Hosiery Co. v. Leader*, 310 U. S. 469 (1940); *Holy Trinity Church v. United States*, 143 U. S. 457 (1892). When Section 115 (f) (1) of the Revenue Act of 1936 is examined in the light of its legislative and judicial back-

ground, it is abundantly clear that Congress did not intend to tax stock dividends of the type involved in this case.

Prior to the decision of this Court in *Koshland v. Helvering*, supra, Congress had interpreted the holding in *Eisner v. Macomber* to mean that stock dividends, of whatever nature, were constitutionally exempt from taxation as income, and the Revenue Acts from 1921 through 1934 had expressly exempted all stock dividends from tax.[19] In the *Koshland* case, this Court held that the *Macomber* case had been given a broader interpretation than the actual decision warranted and that the test for determining the taxability of stock dividends was whether the proportionate interest of the stockholders after the distribution was essentially different from what it had been before.

As we have shown in an earlier portion of this brief, supra, p. 8, the *Macomber* case was not overruled by *Koshland v. Helvering*. In fact, the basic doctrine of the decision itself was reaffirmed, for the

[19] Revenue Act of 1921, c. 136, 42 Stat. 227, Section 201(d); Revenue Act of 1924, c. 234, 43 Stat. 253, Section 201 (f); Revenue Act of 1926, c. 27, 44 Stat. 9, Section 201 (f); Revenue Act of 1928, c. 852, 45 Stat. 791, Section 115 (f); Revenue Act of 1932, c. 209, 47 Stat. 169, Section 115 (f); Revenue Act of 1934, c. 277, 48 Stat. 680, Section 115 (f).

Court expressly recognized that the payment of a stock dividend of the type involved in the *Macomber* case did not constitute income within the meaning of the Sixteenth Amendment. *Koshland v. Helvering*, supra, at 445.

With the decisions of this Court in the *Macomber* and *Koshland* cases before it, Congress in enacting the Revenue Act of 1936 sought to impose an income tax on stock dividends to the extent permitted by the judicial definition of "income" in those cases. The provision in the prior Revenue Acts exempting all stock dividends from tax was eliminated; but in recognition of the limitations laid down in the *Macomber* case and redefined in the *Koshland* decision, Congress provided, in Section 115 (f) (1), that a stock dividend should not be taxable "to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment."

It is apparent from the very wording of Section 115(f) (1) that Congress considered some stock dividends to be nontaxable. Had Congress intended to reach all stock dividends of whatever kind, the obvious way for it to express that purpose would have been simply to strike out the exemption contained in the earlier Act; or it could have restored the provision which appeared prior to the *Macomber* case specifically declaring all stock dividends to be taxable. Instead, Congress carefully added an exception

to the general definition of income contained in Section 22(a) by providing that a distribution in stock to a corporation's shareholders "shall *not* be treated as a dividend to the extent that," etc. There is significance in the fact that Congress phrased this provision in the negative, thereby emphasizing that it was restrictive and that it was intended to exclude certain types of dividends from the operation of Section 22(a). The provision was originally drafted in the affirmative but was deliberately rephrased "in the interest of greater clarity".[20] (Sen. Rept. 2156, pp. 18-

[20]Petitioner seeks to attribute this rephrasing to changes occasioned by the amendment of Section 115(a) in the Senate. (Strassburger Br. p. 12.) This ignores completely the nature of the changes which were made. As originally worded in the House Bill, Section 115(f)(1) provided that a corporate distribution in stock "shall be treated as a taxable dividend to the extent that such distribution constitutes income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution *and represents a distribution of earnings or profits accumulated after February 28, 1913.*" H.R. 12395, 74th Cong., 2d Sess. The italicized portion was not in accord, however, with Section 115(a) as amended by the Senate Finance Committee, since that amendment defined a dividend to include both distributions out of earnings and profits accumulated after February 28, 1913, and distributions out of earnings and profits of the taxable year. The Senate Finance Committee revised the House version of Section 115(f)(1) in two respects: first, it struck out the italicized words, thereby making Section 115(f)(1) consistent with Section 115(a), and second, it reworded the section in the negative. It is obvious that only the former change was referred to by the Senate Finance Committee when it spoke of "changes made necessary by virtue of the reported amendment of Section 115(a)." The rephrasing in the negative was not required by the amendment of Section 115(a) and must have been, as the Senate Report indicates, "in the interest of greater clarity."

19, 74th Cong., 2d Sess.)

Thus it is clear upon the face of the statute itself that at least *some* types of stock dividends were not to be taxed. The types themselves were not described, but the legislative purpose is given content by reference to the judicial background in the light of which Section 115(f) (1) was passed.

If any doubt of the congressional intent could possibly remain, it is completely dispelled by the declarations of purpose which accompanied the enactment of Section 115 (f). (1). See *Duplex Printing Press Co. v. Deering*, 254 U. S. 443, 475 (1921); *Wright v. Vinton Branch of Mountain Trust Bank*, 300 U. S. 440, 463 (1937). The amendment of Section 115 (f) was initiated in the House of Representatives. Representative Vinson, speaking for the Subcommittee on Taxation of the House Ways and Means Committee, voiced that committee's approval of the proportional interest test as defined in *Eisner v. Macomber* and expressly disclaimed any intention to tax stock dividends which came within the rule of that case. Thus, in 80 Cong. Rec., Part 6, pp. 6214-15, 6309-10, the following explanatory statements appear:

> ". . . In no sense is this an attack upon the Eisner against Macomber decision. There are many dividends received in stock and stock rights that are

distinguishable from the character of stock dividend in the Macomber case, supra, and are actual realized taxable income.

As we see it, a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership.

. . . . . .

. . . under the 1934 act there was a provision that said no stock dividend should be taxed. In a very celebrated case, Eisner against Macomber, the Supreme Court held that the tax dividend involved in that case was not taxable. Out of that case grew up the idea that no stock dividend was taxable. I think it was because of that notion that the language to which I have referred, as appears in the 1934 bill, found its way there; that is, that no stock dividend should be taxed.

The proposed plan does not change the law and does not in the slightest degree strike at the decision of the Supreme Court in the case of Eisner and Macomber in respect of a stock dividend where there is no change in the proportion of ownership by the shareholder."

The interpretation given Section 115(f)(1) by the Treasury Department was in accordance with this declaration of congressional intent, and from 1936 until January, 1942, the Department's Regulations expressly exempted stock dividends of the *Macomber*

type from tax.[21] During the intervening years Congress re-enacted Section 115(f)(1) without change,[22] thereby giving its approval to the construction which had been placed upon the section by the Treasury Department in its regulations and in the administration of the Act. It is the settled rule that in the interpretation of a doubtful or ambiguous statute, great weight will be given to the contemporaneous administrative construction by those charged with enforcement of the Act, particularly when Congress, knowing of that construction, thereafter re-enacts the statute without change. *Poe v. Seaborn*, 282 U. S. 101, 116 (1930); *McCaughn v. Hershey Chocolate Co.*, 283 U. S. 488, 492 (1931); *Massachusetts Mutual Life Insurance Co. v. United States*, 288 U. S. 269, 273 (1933).

It is therefore plain that in 1936 when Section 115(f) was amended Congress believed that the decision of this Court in *Eisner v. Macomber* was correct and did not intend to tax stock dividends of the *Macomber* type.

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[21] Treasury Regulations 94, Art. 115-7; Treasury Regulations 101, Art. 115-7; Treasury Regulations 103, Sec. 19.115-7, amended January 19, 1942, by T. D. 5110, 1942-4 Int. Rev. Bull. 7.

[22] Section 115(f)(1), Revenue Act of 1938, c. 289, 52 Stat. 447.

We do not believe that a judicial overruling of the *Macomber* case such as petitioner requests could alter the legislative intent incorporated in Section 115(f) (1) when it was enacted. It is a time-honored rule of statutory construction that a statute speaks as of the date of its enactment and that its language is to be taken in the sense in which it was understood at the time the statute was passed. *Schuyler v. Thomas*, 98 U. S. 169, 172 (1878); *In re Heath*, 144 U. S. 92 (1892); *Platt v. Union Pacific Railroad Company*, 99 U. S. 48 (1878); *Apex Hosiery Co. v. Leader*, 310 U. S. 469 (1940). In the words of Mr. Justice Strong in the *Platt* case, supra, at p. 63:

> "There is always a tendency to construe statutes in the light in which they appear when the construction is given. It is easy to be wise after we see the results of experience . . . But in endeavoring to ascertain what the Congress of 1862 intended, we must, as far as possible, place ourselves in the light that Congress enjoyed, look at things as they appeared to it, and discover its purpose from the language used in connection with the attending circumstances."

It is no answer to this principle to say, as does petitioner, that in using the language employed in Section 115(f) (1) Congress intended to make the taxability of stock dividends coextensive with its taxing

power under the constitution. (Strassburger Br. p. 11.) The taxing power which Congress believed it had in 1936 did not extend beyond the bounds of the *Macomber* case, and Section 115(f) (1) was incorporated in the 1936 Act in express recognition of the constitutional limitations laid down in that case. Even if it should now develop, as urged by petitioner, that the decision in the *Macomber* case was wrong, the fact would remain that Congress in 1936 believed it was correct and enacted Section 115(f) (1) on the assumption and with the assurance that stock dividends of the *Macomber* type would not be taxed."

This Court has held that the legislative intention cannot be enlarged by judicial construction in order to adapt it to a subsequently disclosed constitutional

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"Section 115(f)(1) must be read and construed in the light of every other material part of the tax statute. *White v. United States*, 305 U. S. 281 (1938). Section 112 (b) (2) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, provides in part:

> "No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation . . ."

The same provision appears in Section 112(b)(2) of the Revenue Acts of 1928, 1932 and 1934. Likewise in Section 112(b)(1) of the Revenue Acts of 1928, 1932, 1934 and 1936, Congress has declared that an exchange of business property for property of like kind shall be tax-free. All of these provisions disclose a congressional plan to exempt from tax transactions which do not result in any substantial change in the taxpayer's interest. A stock dividend of common stock on common stock is so closely akin to these tax-free transactions that the exemption of such a dividend from tax is consistent with the general congressional intent demonstrated in these sections.

power. The point is well illustrated by several cases involving the taxability of joint tenancies and estates by the entireties under the 1916 estate tax law. (39 Stat. 777.) In *Knox v. McElligott*, 258 U. S. 546 (1922), the Court had refused to construe the 1916 Act as applicable to a joint estate created prior to 1916, since to give the Act retroactive effect would raise grave doubts concerning the constitutional power to tax interests "vested" in another than the decedent before death and before the Act was passed. Thereafter, in *Tyler v. United States*, 281 U. S. 497 (1930), it became established that because there was a "shift of economic benefit" at the decedent's death there was no constitutional objection to taxing such a tenancy, and in *Gwinn v. Commissioner*, 287 U. S. 224 (1932), it was held that when the Act was made expressly retroactive it could be constitutionally applied to a tenancy created before 1916. Nevertheless, in *Cahn v. United States*, mem. 297 U. S. 691 (1936), when the question arose under the 1918 Act, which, like the 1916 Act, was not expressly retroactive, the Court followed its decision in the *Knox* case and refused to construe the statute as applicable to a joint estate created prior to the Act. In other words, the Court held that the language used in the Revenue Act of 1916 still meant what the Court had

construed it to mean in the *Knox* case, despite the fact that the constitutional doubts which led to the decision in the *Knox* case had since been resolved.

There is nothing in this Court's decision in *United States v. Wrightwood Dairy Co.*, 315 U. S. 110 (1942) (cited at p. 13, Strassburger Br.), which lends support to petitioner's argument. On the contrary, the case is direct authority for the rule of statutory construction which we are asking the Court to apply in this case. The *Wrightwood* case dealt with the intended scope of the Agricultural Marketing Agreement Act of 1937, which authorized the Secretary of Agriculture to regulate the handling of products "directly affecting" interstate commerce. It was urged that the use of the word "directly" indicated an intention by Congress to exercise less than all its constitutional power and did not confer authority over the marketing of intrastate products. The Court found, however, that this language had been adopted from the Supreme Court's opinion in *Schechter Poultry Corp. v. United States*, 295 U. S. 495, 544-8 (1935), where the test was said to be that only those intrastate transactions which "directly affect" interstate commerce come within the reach of the commerce power. The Court concluded from this and other evidence that Congress in enacting the Marketing Act

had intended to exercise its power to the full extent permitted by the commerce clause.

Had the Court in the *Wrightwood* case found that the commerce power was broader than the definition in the *Schechter* case, and had it then construed the Act as encompassing this broader power, despite the fact that Congress had adopted the limitations laid down in the *Schechter* case, it would have done what the petitioner asks the Court to do here. Instead, however, the Court read the *Schechter* case and the words of the Marketing Act together, and the extent of the power which Congress sought to exercise was ascertained by reference to the judicial decision on which the statutory language was based. If in the present case a similar analysis is made of Section 115(f) (1), the intended scope of that provision becomes clear. Congress was adopting as its conception of income the one developed by this Court in *Eisner v. Macomber* and *Koshland v. Helvering*, and the fundamental purpose of Section 115(f) (1) was to make the limitations laid down in those cases a part of the 1936 law.

It is evident from the legislative and judicial background of Section 115 (f) (1), from the limitations implicit in its language, from the interpretation given the section by the Treasury Department's Regulations,

and from the declaration of Congressional purpose which accompanied its passage that Congress in enacting that section did not intend to tax stock dividends of the type involved in *Eisner v. Macomber* and in the case at bar. It is likewise clear that the intent thus incorporated in Section 115(f) (1) when it was enacted would not be altered by a judicial overruling of the *Macomber* case. Since the stock dividend in the instant case is nontaxable under the doctrine of *Eisner v. Macomber*, Congress in passing Section 115 (f) (1) did not intend to subject it to tax. The judgment of the lower court in this case[*] may be affirmed on this ground alone, without the necessity of considering petitioner's request that this Court take the grave step of overruling *Eisner v. Macomber*.

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[*]We express no opinion as to the applicability of this view of Section 115(f)(1) in Strassburger v. Helvering, No. 66.

CONCLUSION

We submit that the judgment of the Circuit Court of Appeals was correct and should be affirmed.

Respectfully submitted,

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Appendix

Constitution of the United States:

Article I, Section 2, Clause 3.—Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons . . .

Article I, Section 9, Clause 4.—No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken . . .

. . . . . .

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration . . .

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from . . . dividends, . . .

. . . . . .

(d) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the

shareholders as provided in section 115.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits . . .

. . . . . .

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

. . . . . .

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder

in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115-7. Stock dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same

[1] See *Eisner v. Macomber* (252 U. S. 189, T. D. 3010, C. B. 3-25); and *Koshland v. Helvering* (56 Sup. Ct. 767, Ct. D. 1124, C. B. XV-1, 219). Compare *United States v. Phellis* (257 U. S. 156, T. D. 3270, C. B. 5, 37); *Rockefeller v. United States* (257 U. S. 176, T. D. 3271, C. B. 5, 34); *Cullinan v. Walker* (262 U. S. 134, T. D. 3508, C. B. 11-2, 55); *Weiss v. Stearn* (265 U. S. 242, T. D. 3609, C. B. III-2, 51); and *Marr v. United States* (268 U. S. 536, T. D. 3755, C. B. IV-2, 116).

corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to

$15,000. On July 1, 1936, it distributed 1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (2): On July 1, 1936, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1936, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (3): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent cumulative preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1936, the company's issued and outstanding stock amounted to 20,000 shares of

common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1936, it paid a dividend on its common stock in preferred stock at the rate of 1/10 share of preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.